Opportunistic M&A in Times of Crisis: The heightened need for Commercial & Operational Due Diligence

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By: Max Sultan, David Lindsay, Nick Coury & Ryan McBride

Introduction

COVID-19 has created unprecedented disruption throughout the global economy and M&A landscape. However, while many deals have been delayed due to widespread uncertainty, companies should not completely write-off opportunities for strategic and opportunistic M&A. Past crises including the 2008 recession have demonstrated the potential value in pursuing and profiting from deals during times of uncertainty.

However, to navigate M&A options in the post-COVID-19 economy, businesses will need to change their approaches to due diligence to accurately assess the future viability of target companies. This paper introduces Applied Value's framework for understanding the impact that COVID-19 has had on different industries and the broader economic landscape in order to drive strategic, high-value M&A.

COVID-19 Industry Impact Framework

From exacerbated structural decline to accelerated growth, COVID-19's impact on industries is a critical consideration for conducting Due Diligence. Companies must be able to command a robust understanding of current & long-term, industry-specific trends that will impact investments during the COVID-19 crisis and beyond (i.e., "the new normal").

Proactively observing and analyzing key industry trends allows investors to make more informed decisions regarding strategy and valuations. Further, insights from Applied Value's Due Diligence services provide valuable information to operators who can use the analysis to feed internal growth strategies and initiatives.

The below Applied Value framework provides an overview of industry impact from the COVID-19 crisis. By categorizing investment opportunities, businesses can use an impact framework to pursue a COVID-19 appropriate Due Diligence process.

COVID-19 Impact
Where does the target investment fall?

	Structural Decline	Temporary Losses	Accelerated Growth
Overview	▪ For some industries, COVID-19 ***exacerbated larger structural declines*** that were already in place ▪ As technologies shift industry trends, it is ***crucial that businesses identify and react to key trends*** in consumer and customer behavior	▪ Losses due to COVID-19 are temporary for some businesses, with ***high potential for recovery*** when economy re-stabilizes ▪ Target companies focused on ***short-term solvency***, providing opportunity for ***distressed investment***	▪ COVID-19 has ***accelerated some industry trends*** such as remote working, delivery services, etc. ▪ This acceleration has provided favorable growth for select industries; however, it can be ***difficult to determine long-term effects***
Diligence Implications	▪ Examine target company's growth strategy and evaluate ***potential for turnaround*** ▪ Detailed analysis of ***industry trends*** to determine optimal path forward for target company	▪ Evaluate nature of industry and business to determine ***rebound potential*** for target company ▪ Robust ***customer interviews*** and ***channel research*** to investigate post-COVID path forward	▪ Determine longevity of industry growth in post-COVID world through ***robust market research*** ▪ Evaluate trend implications and how target company can use them to ***sustain lean growth***

Figure 1: COVID-19 Impact industry framework

Economic uncertainty requires companies to think about deals differently and often more carefully. Robust Vendor Commercial Due Diligence on the sell side can serve as a clear illustration of growth and performance improvement opportunities. By altering Due Diligence to produce effective predictions about companies' future success, PE funds can secure profitable deals with significant post-downturn returns.

M&A during economic downturns

Observing past downturns reveals the latent M&A opportunity that still exists in periods of economic decline. While different from the current crisis, the dot-com bust in the late 1990s and the Great Recession of 2008 both fostered similar economic conditions to the current conditions of the COVID-19 economy and can provide an instructive case for understanding how M&A behavior can and should change.

During these economic slowdowns a recurrent trend held: after years of high growth, both deal count and value declined significantly and took years to recover to pre-downturn levels. These downturns predictably lead to company management being wary of making any large structural changes to their organization. CEO confidence on both the buy and sell side dropped significantly.

Global M&A Activity since 1990

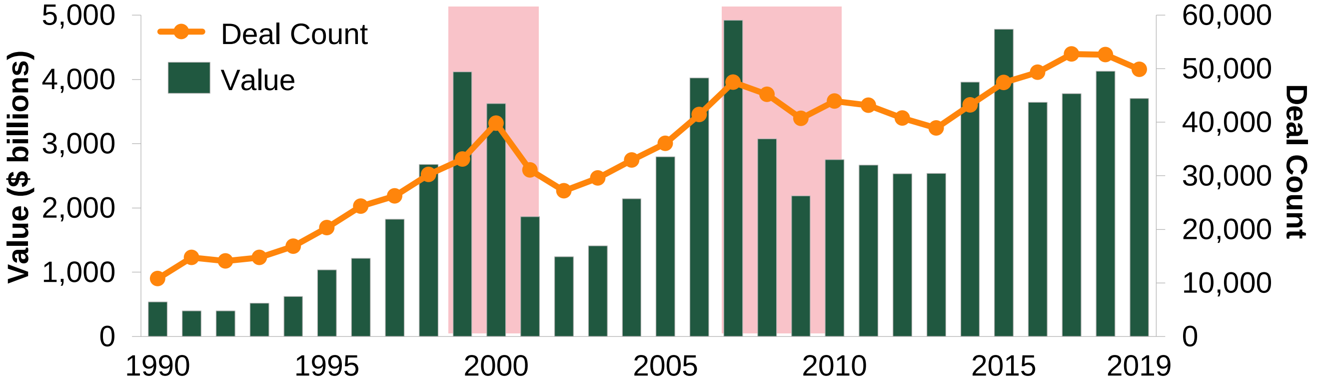

Figure 2: M&A activity over time. Source: IMAA Institute

As revealed during these eras, in times of uncertainty or decline the typical deal process will inevitably look different than it does in times of growth. Despite these changes, it is essential to ***recognize that there will be opportunities***, even as deal activity falls and CEOs express caution.

Although we are only a few months in to the current COVID-19 crisis, we have already seen this trend develop. A sample of deals already executed between March and May 2020 illustrate the opportunity:

Key Deals Executed during COVID-19 Pandemic

Size	Details
$5.2 billion	KKR acquires waste-management business Viridor Ltd. From Pennon Group Plc.
$356 million	Deccan Value Investors acquired auto component manufacturer Amtek Auto.
$87 million	Eleda Infra Service Group, a provider of engineering, excavation & construction services, was acquired by Altor Equity Partners.
$75 million	Lencore Acoustics, a manufacturer of commercial audio systems, was acquired by Emmis Communications.
$33 million	Urbas Grupo Financiero acquired construction and engineering provider Murias Grupo.

Figure 3: Deals executed during COVID-19

Valuations in private markets have historically ticked down during recessions in conjunction with the equity markets and overall economic conditions. In the Great Recession, buyout multiples dropped significantly and did not return to pre-recession levels until 2014.

Median EV/EBITDA Buyout Multiples

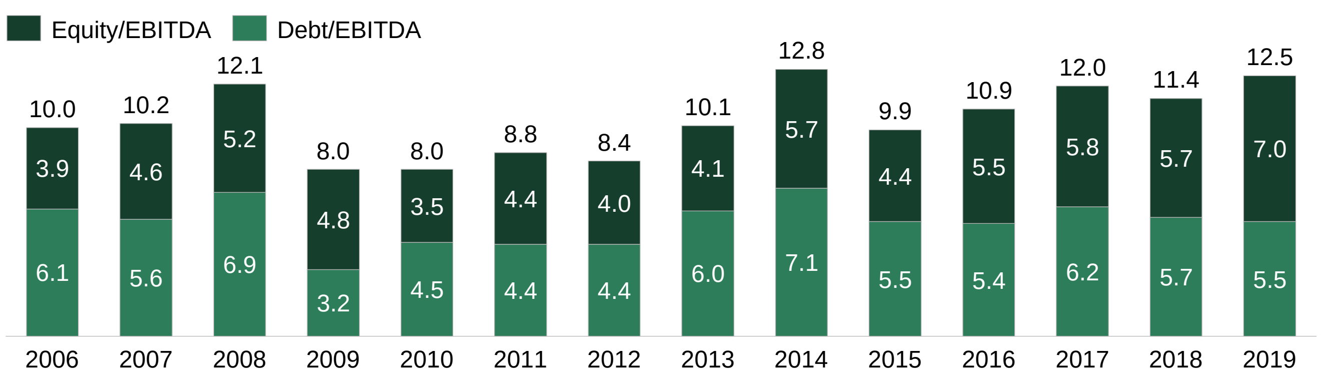

Figure 4: Buyout multiples since 2006. Source: Pitchbook

While fewer deals are executed during periods of uncertainty, and at lower multiples, there are still deals to be done. In past recessions, returns of companies that made acquisitions during these times outperformed those of their industry peers. There are a few reasons that explain this phenomenon:

1) Entry prices drop significantly.
2) Lower valuations allow organizations to go after targets previously out of reach, making it easier to gain market share by acquiring additional capacity, ability, and/or efficiencies.
3) Fewer companies are bidding since those heavily reliant on debt and equity to execute deals may have to take a backseat.

In order to capitalize on these conditions and find opportunity in periods of downturn or instability, businesses must direct additional and careful attention to their diligence efforts, with a focus on understanding true drivers of value and future prospects for industries and companies.

The following section outlines Applied Value's framework for conducting Due Diligence and Vendor Commercial Due Diligence (VCDD) during times of crisis or downturn.

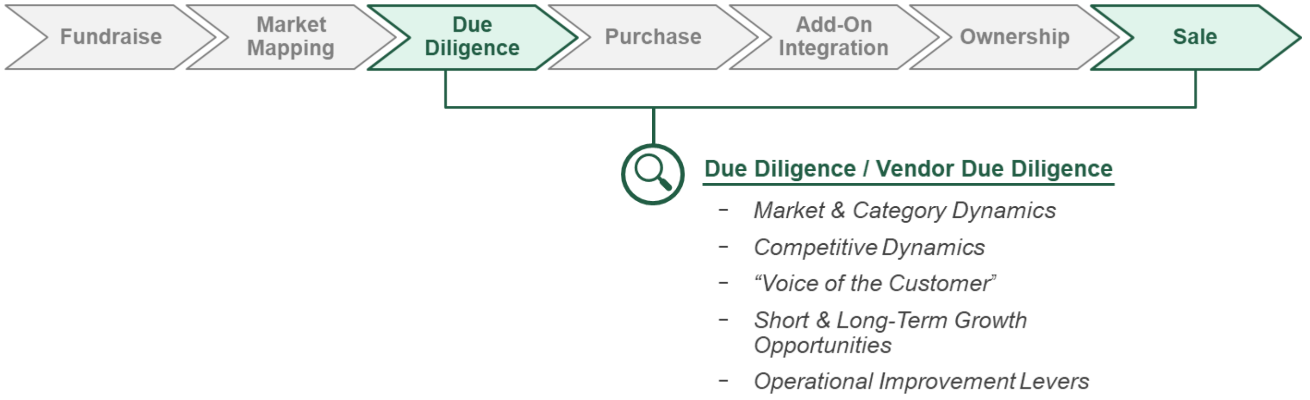

Figure 5: Deal process overview

Due Diligence

In times of crisis, due diligence requires a honed focus on understanding the core drivers of value for a company. To what extent is performance either rising or falling a result of the current downturn? Or is it more a result of an underlying structural problem that is only being uncovered due to external circumstances? Thorough Commercial and Operational Due Diligence that dives into the five topics below will flush these considerations out and uncover structural trends that can suggest how a potential portfolio company will perform post-crisis.

Selected components of a successful due diligence

Commercial Due Diligence (CDD)	5 Operational Due Diligence (ODD)
1 Market & Category Dynamics	Pricing opportunities & governance
2 Competitive Dynamics	Sourcing & supply chain cost reductions
3 "Voice of the Customer"	SG&A efficiency
4 Short & Long-Term Growth Opportunities	Working Capital & CAPEX

Figure 6: Key aspects of due diligence

1) Served market dynamics such as overarching megatrends, growth drivers, and risks.

In normal times, megatrends and market dynamics are key inputs for developing investment theses and predicting future performance. During economic downturns, especially those caused by external shocks like COVID-19, previous trends that are subject to major disruption offer little valuable insight. Dramatic changes in previously held trends can both cripple previously strong industries and boost struggling ones. During Due Diligence, companies must consider past, current, and future market states. Clearly identifying 1) the size and growth of the market, 2) key trends and drivers, and 3) the market structure will ensure that the investment will not only survive the current crisis but weather any future downturns.

Consider trade shows. The COVID-19 pandemic halted all large conventions. But, are the recent struggles just a result of the drop in travel due to the pandemic? Or was the drop a result of structural decline? Once the pandemic ends, will individuals return to trade shows? Or will they decide that the substitutes developed during quarantine are sufficient, resulting in reduced need for trade shows in the future? This level of analysis is critical when looking at any potential acquisition.

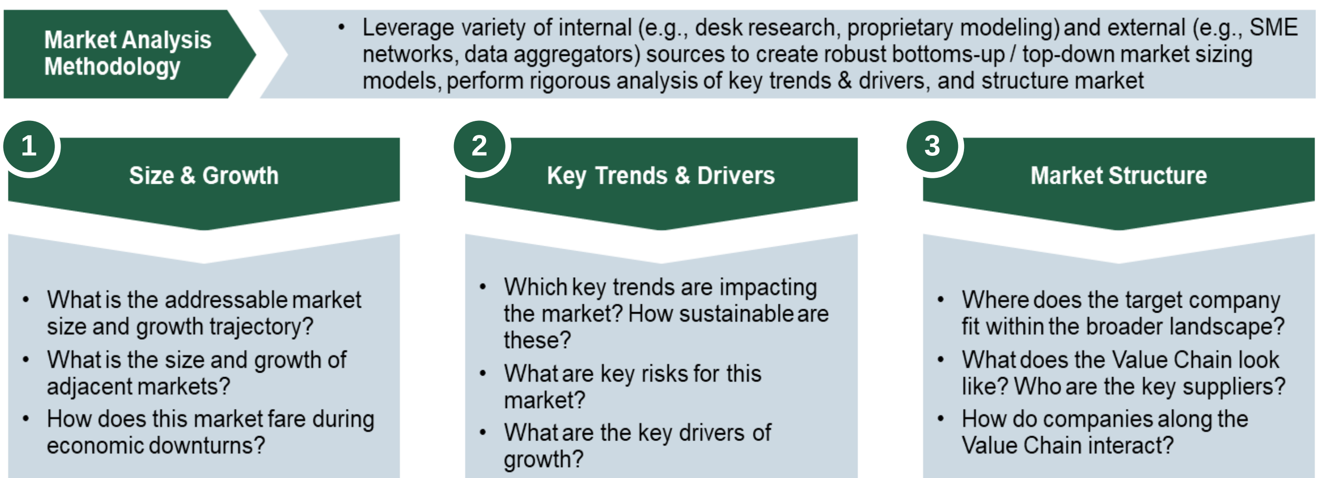

Figure 7: Market analysis methodology

2) The competitive dynamics & key sources of differentiation existing in the market.

When thinking about competitive dynamics, one must assume that competitive landscapes will look different on the other side of a downturn. Many companies will either shutter or change their core operations to adapt to new market pressures, meaning a strong due diligence will put a great emphasis on predicting future states by looking at key drivers of business success. Companies that differentiate themselves from the rest of the pack, whether with product offerings, customer segmentation, or technological advances, have a better chance of withstanding the pressures that arise during a downturn.

Activity	Key Questions	Methodology
Competitive Landscape Mapping	› What is the nature of the competitive landscape? Is competition local / regionalized? › What are the key strategies employed by relevant competition? › What is the degree of fragmentation or consolidation? Threat of new entrants? Barriers to entry?	› Conduct a broad competitive overview and strategic mapping of addressable market segments › Profile the strategies of relevant players including product lines, service levels, value propositions, target segments, operational platform, etc.
Product / Service Offering Portfolio Benchmarking	› How is the target positioned relative to competitors? › What are the sources of differentiation? How sustainable are these? › How do competitors' products / services compare to target company's offerings?	› Evaluation and benchmarking of target company's products and / or service offerings relative to other players in the competitive set › Leverage expert network to gain valuable competitive insights
Competitive Profiles / Potential M&A Targets	› How large is my competitive set? › How much private investment is in this space? › Is there significant opportunity for inorganic growth?	› Leverage competitor research to develop list of potential M&A targets for inorganic target company growth › Map targets within core and adjacent markets with preliminary revenue and EBITDA margin estimates based on available data

Figure 8: Competitive dynamics questions & methodology

3) The "Voice of the Customer:" customer satisfaction, price and budget sensitivity, loyalty.

During economic downturns, demand usually softens, as individuals and companies alike prefer to hold their assets rather than spend them. As a result, The "voice of the customer" is more important to listen to than ever before. Companies must deeply consider not only how customers are spending, their price and budget sensitivity, during the downturn, but how it might permanently change in the future. Will substitutes take place of the product or service offered? Will technology take over? Customer loyalty truly drives revenue stability, so digging into customer profiles proves exceedingly important. Ensuring revenue resiliency is a must.

Customer / Consumer Surveys	Customer / Key Account Interviews	Channel Assessment
› What room for improvement exists within key relationships? › How sticky are customer relationships? › What is my NPS? Other relevant quantitative metrics?	› What is the perception of the target company at key customers? › What specific feedback and room for improvements exist within relationships? › How do key customers perceive the market outlook?	› How do key channels operate regarding purchasing decisions? › How are the target company's products placed in channels? › If applicable, what does shelf space look like across key channels?

Figure 9: COVID-19-19 Impact industry framework

4) Short & long-term growth opportunities.

During economic downturns, a company's first focus often falls to mitigating risk in the short-term, and emphasis on investing in profitable future growth is pushed to the side. However, companies with strong growth strategies are most likely weather a downturn and come out the other side stronger and well positioned for the long-term. In the current market environment, we sometimes see organizations sacrificing profitability for the sake of growth; however, spending more to acquire customers than profit generated, for example, is an example of an unhealthy growth strategy. So, as investors are assessing target companies, understanding their approach to growth, even if it is not as applicable given the external circumstances, allows buyers to best project future performance.

Examining the validity of both organic growth plans, such as expanding upon their current market or geographic expansion, as well as inorganic growth opportunities, like leveraging future M&A to accelerate expansion, is key to understand where a company expects to stand one, five, and even ten years into the future. Knowing how a potential acquisition thinks about their future, and how achievable management's business plan is, will be essential for a successful acquisition with high returns.

Key issues		› What are the organic growth opportunities for the business? (e.g. new product development, geographic expansion, new pricing strategy)
		› Are there any acquisition targets that would drive growth? (e.g. acquire new customer base, new capability)
		› How should growth opportunities be prioritized?
		  › What is the potential revenue upside?
		  › What are the execution risks?

Methodology	**Growth modeling**	› Revenue upside can be quantified through growth modeling, which can account for price and volume assumptions, in addition to macro factors e.g. inflation, GDP
	SME interviews	› SME, customer and competitor interviews to identify and test growth opportunities
	Desk research	› Third-party sources such as industry reports will supplement interview insights

Figure 10: Growth strategy assessment methodology

5) Levers for operational improvement.

Establishing an in-depth view of operational improvements can help to quantify additional value opportunities. Companies should look across the P&L and balance sheet, staring with considerations like pricing and opportunities for better customer segmentation and moving through cost reductions by benchmarking costs and assessing areas for improvement. Post-acquisition changes to operational strategies like supplier footprints and make vs. buy decisions can drive cost savings and quality improvements. Dynamic evaluation models including supplier evaluations throughout Due Diligence will ensure acquired companies can withstand current and future economic uncertainties and help distinguish potential market leaders.

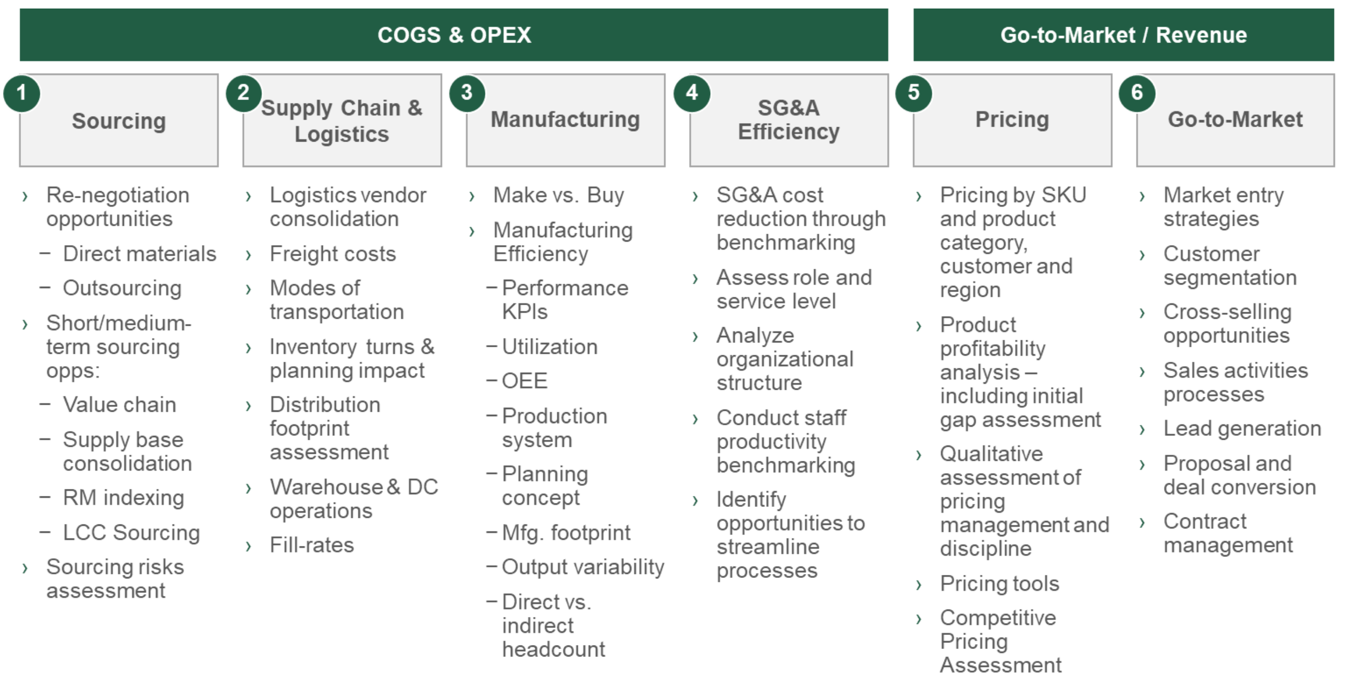

Figure 11: Key levers for operational improvement

Vendor Commercial Due Diligence

Lean Growth, a set of principles focus on freeing up resources for re-investment in profitability drivers, provides a valuable framework for considering Commercial Due Diligence. Industry leaders excel in both the commercial and operational sides of the business. They understand their customers, have measured value-focus in all functions, and continuously improve. In times of uncertainty, these skills are evermore essential for survival.

While Lean Growth mindsets can prove invaluable for implementing operational changes during downturns, companies looking to sell must effectively convey the fundamentals of their business if they want to secure capital in uncertain times. Executing Vendor Commercial Due Diligence (VCDD) allows companies to position themselves in the best light possible, exhibiting their strengths to potential buyers. Another way to think of this is “dressing the bride.” Leadership can tell a convincing story by demonstrating the main drivers of resilience and clearly articulating strategic opportunities.

Areas of Focus while “Dressing the Bride”	
Resilience	**Strategic Opportunities**
› Forward-thinking scenario planning	› Technological advancements
› Relation to changing megatrends	› New market expansion
› Captive and loyal customer base	› Reaction to market volatility
› Excellent cost structure & pricing execution	› Business unit rationalization

Figure 12: How to “dress the bride” during VCDD

VCDD can clearly articulate growth and performance improvement opportunities, and these aspects should be rigorously quantified. During downturns, companies should consider third-party VCDD, which can more reliably capture the “Voice of the Customer,” giving potential buyers confidence rooted in first-hand insights about companies’ customer satisfaction and growth opportunities.

Additionally, robust VCDD can demonstrate performance in both pre- and post-COVID-19 times, identifying which crisis-related effects are temporary, which will bounce back, and which were already positioned for structural decline or instability and were revealed by crisis. Breaking down these trends in a deep VCDD is key in understanding the full scope of an industry and the potential future performance of companies within.

What's next?

These unprecedented times stemming from the COVID-19 outbreak have left many confused as to what M&A activity will look like once we come out on the other side. What makes this economic downturn different from the dot-com bust of the late 1990s and the Great Recession of 2008 is the high level of dry powder in private markets. PE dry powder inventory has risen to record highs in the past few years as investors are sitting longer on their raised funds.

Private Equity Dry Powder

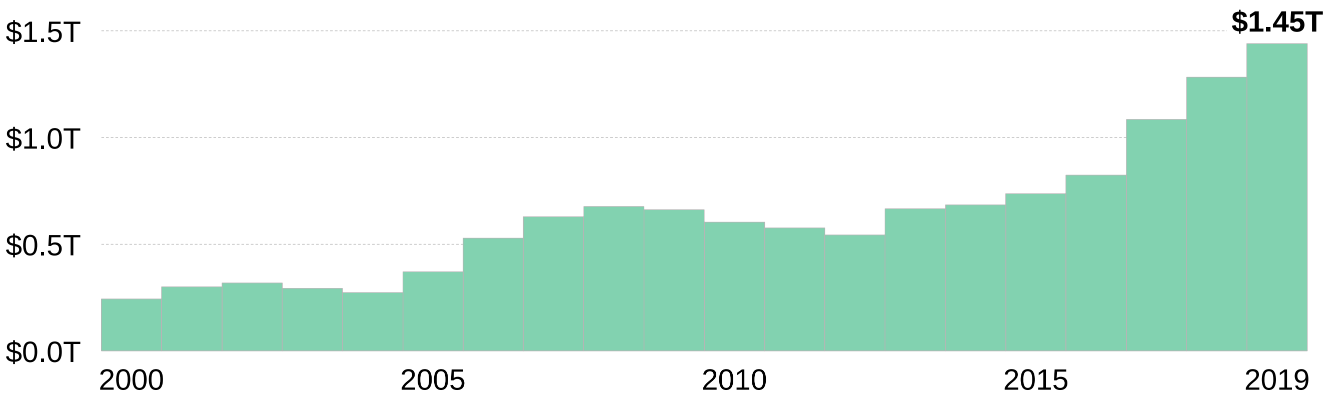

Figure 13: PE dry powder since 2000. Source: Preqin

What does this mean for private equity post-pandemic? There will likely be a decrease in yearly deal count as many firms hold on to their assets at the start of the pandemic, focusing mainly on saving any sinking ships rather than sourcing new opportunities. However, because of the high levels of undeployed capital among investors right now, PE buyers may be more willing and able to continue paying premium multiples for quality assets.

Continuing to be opportunistic in sourcing, acquisition, and ownership will be essential as firms strive to embrace the "new normal" emerging from this temporary setback. While leadership may have to adjust their previous ways of working to fit the new social and economic environment, by taking advantage of the situation with intentional actions, they will only emerge stronger and more resilient.

For more information, please do not hesitate to reach out to:

Max Sultan
Senior Manager
+ 1 978 760 9971

New York

David Lindsay
Manager
+ 1 978 243 7873

New York

Nick Coury
Consultant
+ 1 617 283 5822

San Francisco

Ryan McBride
Consultant
+ 1 978 243 7873

New York

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